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In The

Supreme Court of the United States

October Term, 1994

LAIDLAW HOLDINGS, INC., LAIDLAW EQUITIES, INC., LAIDLAW HOLDINGS ASSET MANAGEMENT, INC., GOTTFRIED VON MEYERN-HOHENBERG, MICHAEL F. FAHEY, JR., DAVID N. BOTTOMS, WALTER H. BAUR and HUGH REGAN,

Petitioners,

vs.

STEPHEN J. POLLACK, FRANK A. ARIOSTA, S.I. ORTHOPAEDICS TARGET PLAN, S.I. ORTHOPAEDICS VOLUNTARY PLAN, MICHAEL POLLACK and WILLIAM M. POLLACK TRUST,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether the Court of Appeals for the Second Circuit erred in holding that investments in mortgage participations sold by a securities broker to unsophisticated investors were securities within the meaning of the federal securities laws?

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Respondents.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

BRIEF IN OPPOSITION

STATEMENT OF THE CASE

The petition seeks review of a decision by the Second Circuit reversing a decision of the United States District Court for the Southern District of New York, which

granted a motion dismissing plaintiffs' amended complaint.[1] As alleged in the amended complaint, which must be taken as true for purposes of a motion to dismiss, plaintiffs are passive and unsophisticated investors who entrusted their money to the Laidlaw defendants. App. D-2-3, ¶¶ 4-8; D-6-7, ¶¶ 20-24; D-14, ¶ 42(d). The Laidlaw defendants include Laidlaw Asset Management, a registered investment advisor which managed plaintiffs' discretionary accounts; Laidlaw Equities, a registered broker-dealer which bought and sold securities for those accounts; Laidlaw Holdings, which owned Laidlaw Asset Management and Laidlaw Equities; and the officers and directors of the three corporate defendants, who are named as defendants under a controlling persons theory pursuant to section 15 of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. § 77o, and section 20(a) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78t. App. D-3-5, ¶¶ 9-19; D-14-15, ¶ 44. At all relevant times, plaintiffs' discretionary accounts were managed by Walter L. Twiste ("Twiste"),[2] who was president, chief executive officer and a director of Laidlaw Holdings and Laidlaw

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[1] As used herein, the term "plaintiffs" refers to respondents Stephen J. Pollack, Frank A. Ariosta, S.I. Orthopaedics Target Plan, S.I. Orthopaedics Voluntary Plan, Michael Pollack and William M. Pollack Trust. The term "Laidlaw defendants" refers to Laidlaw Holdings, Inc., Laidlaw Equities, Inc., Laidlaw Holdings Asset Management, Inc., Gottfried von Meyern-Hohenberg, Michael F. Fahey, Jr., David N. Bottoms, Walter H. Baur and Hugh Regan. Laidlaw Holdings, Inc. is referred to as "Laidlaw Holdings"; Laidlaw Equities, Inc. is referred to as "Laidlaw Equities"; and Laidlaw Holdings Asset Management, Inc. is referred to as "Laidlaw Asset Management".

[2] Twiste, who is named as a defendant in the amended complaint, is not a party to the petition.

Equities, and vice-chairman of Laidlaw Asset Management. App. D-4, ¶ 13.

For more than eight years, in accordance with plaintiffs' instructions, Twiste invested plaintiffs' funds in conservative, low-risk investments such as bonds and other debt instruments which would normally be considered securities. App. D-7, ¶ 24. Beginning in approximately 1985, Twiste began to invest a portion of plaintiffs' funds in "promissory notes", with terms of one to three years, which he described as mortgage investments that were "sound, guaranteed and secured" and consistent with plaintiffs' investment objectives. App. D-7-8, ¶¶ 25-26. In June 1990, plaintiffs learned that Twiste had left the Laidlaw companies and had been admitted to a mental institution; he had stolen money from various clients' accounts; and the mortgage investments were not sound, guaranteed and secured as represented by Twiste, but were participations in mortgages that were unsecured, unrecorded, uncollateralized and, in some cases, oversubscribed and fictitious. App. D-9-11, ¶¶ 31-34; D-18, ¶ 56.[3]

In their amended complaint, plaintiffs asserted violations of the securities laws[4] and the Racketeer Influenced

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[3] In May 1991, the Securities and Exchange Commission ("SEC") commenced proceedings against Twiste and Laidlaw, alleging fraud and failure to maintain adequate internal controls, which resulted in remedial sanctions, App. A-4 n.1; D-12, ¶ 40.

[4] Plaintiffs alleged violations of sections 5(a), 5(c) and 12(1) of the 1933 Act, 15 U.S.C. §§ 77e(a), 77e(c) and 77l(1) (Count I); § 12(2) of the 1933 Act (Count II); and § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (Count

and Corrupt Organizations Act ("RICO"), as well as various common law claims. Plaintiffs specifically alleged that the investments in the mortgage participations at issue were "notes" and "investment contracts" under the securities laws, § 2(1) of the 1933 Act, 15 U.S.C. § 77b and § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10). App. D-12-14, ¶¶ 41-42.[5] In granting the Laidlaw defendants' motion to dismiss, the district court ruled that there was no set of facts plaintiffs could prove that would enable them to demonstrate that the investments in mortgage participations were notes or investment contracts. App. B-4-11. The district court certified the issue under 28 U.S.C. § 1292(b), and the Second Circuit held on appeal that the mortgage participations alleged in the amended complaint were notes under the "family resemblance" test enunciated in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), without reaching any of the other issues raised. App. A-6-7, 8, 14.[6]

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[5] The amended complaint specifically alleged that the investments had each of the characteristics identified by this Court in the applicable case law that would make them "notes" and "investment contracts". *Id.*

[6] Plaintiffs urged the Second Circuit to hold that the transactions at issue were investment contracts, but the court declined to decide that issue in view of its holding that the mortgage participations were notes. App. A-8 n.5. Plaintiffs also asked the Second Circuit to review the district court's decision that there is no corporate liability under RICO, but the court declined to consider that issue because the district court had not certified it and plaintiffs had been granted leave to replead. App. A-6 n.2.

SUMMARY OF ARGUMENT

This case is not certworthy because petitioners simply argue that the Second Circuit "misapplied" the *Reves* standards in connection with a motion to dismiss. Moreover, the Second Circuit did not misapply the *Reves* standards; it held that investments in mortgage participations sold to unsophisticated investors are "notes" under the securities laws. To the extent that petitioners argue that the securities broker and investment advisor who defrauded plaintiffs should be viewed as the "proper purchaser" here, and the securities laws should not apply because that securities broker and investment advisor was "sophisticated", their argument should be rejected because it would relieve brokers and investment advisors of liability for fraud under the securities laws. There is no conflict between the Second Circuit's decision and any decision of this Court or any other court, and the Second Circuit was correct in its judgment that there is no alternative regulatory scheme that would adequately protect plaintiffs in this case.

REASONS FOR DENYING THE WRIT

1. This Case Is Not Certworthy.

The essence of petitioners' argument is that "the Court of Appeals misapplied the factors adopted by this Court in *Reves*." Petition at 9. As petitioners' articulation of their own argument demonstrates, this case presents no novel questions of law, no disagreements between the circuits and no conflict with the governing precedent of

this Court. The parties agree that *Reves* is the applicable precedent, and the principles enunciated in *Reves* are clear; petitioners' claim is that *Reves* was "misapplied". Moreover, petitioners' claim is that *Reves* was misapplied in connection with a motion to dismiss. Thus, this case does not raise important questions of law, and petitioners will have ample opportunity to seek review of the very questions they raise here if they lose on the merits.

2. The Second Circuit Did Not Misapply The *Reves* Factors.

Petitioners claim that "[p]rior to the decision below, the cases overwhelming [*sic*] held that participations in commercial loans were not securities". Petition at 10 n.2. That is simply inaccurate. Courts throughout the country have consistently held that investments in loans are securities when they are sold as investments to unsophisticated investors. *Wright v. Downs*, No. 91-2050, 1992 U.S. App. LEXIS 17384, at *10 (6th Cir. July 17, 1992); *S.E.C. v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125, 1131 (9th Cir. 1991); *Zolfaghari v. Sheikholeslami*, 943 F.2d 451, 455 (4th Cir. 1991); *United States v. Farris*, 614 F.2d 634, 641 (9th Cir. 1979), *cert. denied*, 447 U.S. 926 (1980); *Mercer v. Jaffe, Snider, Reitt & Heuer, P.C.*, 736 F. Supp. 764, 769-70 (W.D. Mich. 1990), *aff'd without opinion*, 931 F.2d 893 (6th Cir. 1991); *Melton v. Unterreiner*, 436 F. Supp. 740, 742 (E.D. Mo. 1977), *aff'd in relevant part*, 575 F.2d 204 (8th Cir. 1978). *See Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137-38 (2d Cir. 1976) (promissory notes sold as

investments are securities even where the investor is sophisticated).[7]

To overcome this obstacle, petitioners make the argument (which they barely mentioned in the court below) that the Second Circuit failed to focus on the proper purchaser. They contend that Twiste – not plaintiffs – was the purchaser of the mortgage investments, and, as a "professional money manager", he was quite sophisticated and did not need the protection of the securities laws. Petition at 10-11. If this argument is accepted, many transactions involving fraud by securities brokers in the management of discretionary accounts would be removed from the protection of the securities laws.

There are many reasons why this argument is untenable. First, the securities laws were designed to deter fraud on the part of brokers and investment advisors, as well as issuers; there are legions of cases holding brokers and investment advisors liable for violating the securities laws.[8] Second, petitioners' argument ignores the fact that

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[7] The cases make clear that it is not necessarily the instrument itself, but the way it is sold, that gives rise to the protections of the securities laws. *Compare Marine Bank v. Weaver*, 455 U.S. 551 (1982) (certificates of deposit are not securities) *with Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985) (certificates of deposit are securities).

[8] *E.g., Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993) (defining "suitability" claim); *O'Connor v. R.F. Lafferty & Co., Inc.*, 965 F.2d 893, 897-99 (10th Cir. 1992) (same); *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 493-94 (6th Cir. 1990) (same); *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 5 (1st Cir. 1983) (same); *see also Olson v. E.F. Hutton & Co.*, 957 F.2d 622,

the amended complaint alleges that Twiste and the Laidlaw corporate defendants were sellers or agents of the sellers. App. D-10, ¶ 34; D-14, ¶ 43.[9] Third, even if Twiste and the Laidlaw corporate defendants are considered agents of the purchasers, the securities laws prohibit fraud "in connection with" the purchase or sale of securities and therefore apply to agents of purchasers as well as agents of sellers. 15 U.S.C. § 78j(b).

3. The Second Circuit's Holding Does Not Conflict With A Decision Of The Tenth Circuit.

Petitioners contend that the Second Circuit's holding conflicts with the Tenth Circuit's decision in *Resolution Trust Corp. v. Stone*, 998 F.2d 1534 (10th Cir. 1993), where the court held that the purchase of automobile loans by a savings and loan did not involve the sale of a security. That case is readily distinguishable from this one because

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628 (8th Cir. 1992) (defining "churning" claim); *Hotmar v. Lowell H. Listrom & Co.*, 808 F.2d 1384, 1385-86 (10th Cir. 1987) (same); *M & B Contracting Corp. v. Dale*, 795 F.2d 531, 533 (6th Cir. 1986) (same); *Tiernan*, 719 F.2d at 5 (same); *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1367-68 (7th Cir. 1983) (same); *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1416-17 (11th Cir. 1983) (same); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981) (same); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 820-21 (9th Cir. 1980) (same); *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1069 (2d Cir. 1977), *cert. denied*, 434 U.S. 1035 (1978) (same).

[9] *See Pinter v. Dahl*, 486 U.S. 622, 647 (1988) (extending liability as a "seller" under § 12(1) of the 1933 Act to "those who solicit securities purchases" if "motivated at least in part by a desire to serve [their] own financial interests").

it involved the sale of commercial paper to a sophisticated bank in a transaction that is not normally perceived as an investment in securities.[10]

The Second Circuit recognized this distinction when it distinguished the instant case, involving the sale of investments to unsophisticated purchasers, from its own decision in *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51, 55-56 (2d Cir. 1992), *cert. denied*, 113 S.Ct. 2992 (1993), which involved the sale of participations in commercial loans by sophisticated banks to sophisticated banks. App. A-11.

4. The Second Circuit's Holding Does Not Conflict With This Court's Holding In *Santa Fe*.

Petitioners argue that the Second Circuit's decision conflicts with this Court's decision in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), where the Court held that not all breaches of fiduciary duty give rise to an action for securities fraud. Petition at 12-13. The Court did not hold that all breaches of fiduciary duty resulting from the commission of fraud fall outside the ambit of the securities laws. Where, as here, a broker and investment advisor managing a discretionary account commits fraud in the sale of an investment to an unsophisticated investor, the attendant breach of fiduciary duty argues in favor of the applicability of the securities laws, not against it.

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[10] In an effort to make this case sound like *Stone*, petitioners repeatedly describe the transactions at issue as "commercial" mortgages. Petition at i, 5, 6, 11. That word does not appear in the amended complaint.

5. The Second Circuit Did Not Misapply The Fourth *Reves* Factor.

Petitioners argue that this Court should review the Second Circuit's decision because they disagree with that court's assessment of the extent to which there are alternative regulatory schemes rendering application of the securities laws unnecessary. Petition at 13-15.

Petitioners argue, first, that the Investment Advisors Act of 1940, 15 U.S.C. § 80b-1, *et seq.* ("IAA"), provides adequate protection. This overlooks the fact that the IAA applies only to one defendant; it limits any recovery to the amount of the management fee; and it was designed to complement, rather than substitute for, the securities laws – a point made by the Second Circuit but totally ignored in the petition. App. A-14. Furthermore, the IAA does not even apply unless the investment is a security. *See, e.g., Mechigian v. Art Capital Corp.*, 639 F. Supp. 702, 705-06 (S.D.N.Y. 1986).

Petitioners argue, second, that the Employment Retirement Income Security Act, 29 U.S.C. § 1001, *et seq.* ("ERISA"), provides an alternative regulatory scheme. But ERISA applies to only two of the six named plaintiffs. Moreover, it does not reduce the risk of the instrument, *Reves*, 494 U.S. at 67; rather, ERISA only applies an alternative means of recovery for a percentage of the transactions – a factor also noted by the Second Circuit but ignored by petitioners. App. A-14.

Petitioners argue, third, that under New York State law, extensive statutory regulation of mortgages and mortgage brokers already exists. This ignores the fact that

it is the securities broker, not the mortgage broker (who is bankrupt), that plaintiffs seek to hold liable. It also ignores the fact that the investments at issue here, which are alleged to be "uncollateralized, speculative participations in mortgages", are not analogous to recorded mortgages obtained in face-to-face negotiations with a professional licensed under state law such as an attorney – also noted by the Second Circuit but ignored in the petition. App. A-12-14.

The securities laws provide a unique regulatory scheme and may be the only means by which plaintiffs can obtain a meaningful recovery. Twiste, who is bankrupt, was able to defraud plaintiffs, in part, because he was not subjected to adequate internal controls. App. B-2; D-12, ¶ 40; D-14-15, ¶¶ 44-45. The securities laws require corporations and individuals to implement adequate controls before they can hold themselves out as securities brokers and investment advisors soliciting funds from the general public. The securities laws attempt to enforce that requirement, in part, by imposing controlling persons liability on corporations and individuals who fail to implement adequate controls.

The Second Circuit was correct in recognizing that the securities laws, through the imposition of controlling persons liability, may be the only means by which plaintiffs can obtain a meaningful recovery in this case.

CONCLUSION

For the foregoing reasons, the writ should be denied.

Respectfully submitted,

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